CEIVED

MAY 1 9 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

LEVINE, BLASZAK, BLOCK & BOOTHBY
1300 CONNECTICUT AVENUE, NW
SUITE 500
WASHINGTON, D.C. 20036-1703
(202) 223-4980
FAX (202) 223-0833

May 19, 1995

DOCKET FILE COPY ORIGINAL

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW - Room 222
Washington, D.C. 20554

Re: Price Cap Performance Review for Local Exchange Carriers CC Docket No. 94-1

Dear Mr. Caton:

Pursuant to Section 1.1.429 (h) of the Commission's Rules, attached please find an original and eleven copies of the Petition for Expedited Partial Reconsideration of the Ad Hoc Telecommunications Users Committee in the above captioned matter. Please date stamp the additional copy and return it with our messenger.

If you have any questions regarding this filing, please do not hesitate to call us.

Sincerely,

James S. Blaszak

200.12 PETCOV.DOC

No. of Copies rec'd 0+11
List ABCDE

RECEIVED

MAY 1 9 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1

DOCKET FILE COPY ORIGINAL

PETITION FOR EXPEDITED PARTIAL RECONSIDERATION OF THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE

Economic Consultants

Dr. Lee Selwyn
Patricia D. Kravtin
Economics and Technology, Inc.
One Washington Mall
Boston, MA 02108-2617
617/227-0900

James S. Blaszak, Esq
Levine, Blaszak, Block & Boothby
1300 Connecticut Avenue
Suite 500
Washington, DC 20036
202/223-4980

May 19, 1995

200.12 prconcvr.doc

TABLE OF CONTENTS

SUMMARY

The Ad Hoc Telecommunications Users Committee urges the Commission to expeditiously reconsider portions of its First Report & Order in this proceeding. Expeditious action on this petition for reconsideration is necessary because errors in the First Report & Order expose telecommunications service consumers to excessive rates for interstate access service. The excessive rates are reflected in the 1995 annual access tariffs which are pending before the Commission.

The Commission should reconsider the following aspects of the First Report & Order:

- In setting the highest X-Factor the Commission erred in relying on USTA's January 1995 update to its TFP study. Parties pointed to data inconsistencies in the update and explained why the updated study is unreliable. The First Report & Order acknowledges these arguments but does not explain why these arguments are without merit and why the Commission relied on the USTA update. This error caused the highest optional X-Factor to be at least 0.5% too low, when the offset is calculated on a company wide basis.
- The First Report & Order erred in eliminating the sharing requirement for LECs who elect to operate under an X-Factor of 5.3%. This X-Factor is insufficient, even for an interim plan, to assure that the LECs' interstate access service rates are just and reasonable. Although the Commission

has some flexibility in selecting the method it uses to regulate the rates of the carriers subject to its jurisdiction, it is not free to adopt an approach which would allow carriers unlimited excessive earnings, *i.e.,* earnings outside the zone of reasonableness. The First Report & Order is somewhat ambiguous on the Commission's intentions on this matter. If the Commission believes that it decided that it may allow the price cap LECs to earn returns outside the zone of reasonableness for interstate access service, the Commission should reconsider that aspect of the First Report & Order.

- And finally, the Commission should set the offset factors based on the interstate operations of the price cap LECs. Utilization of total company data on productivity and the input cost differential is inconsistent with the teachings of the Supreme Court on the need to segregate interstate and intrastate operations for purposes of public utility regulation. Moreover, the First Report and Order is factually in error in suggesting that interstate TFP cannot be separately determined.

Accordingly, the Ad Hoc Telecommunications Users Committee respectfully requests that the Commission expeditiously reconsider limited

RECEIVED

MAY 1 9 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1

PETITION FOR EXPEDITED PARTIAL RECONSIDERATION

The Ad Hoc Telecommunications Users Committee ("Ad Hoc Committee") hereby requests partial reconsideration of the Commission's First Report & Order in the above-captioned proceeding.[1] In important respects, the First Report & Order is arbitrary, capricious and unlawful. Specifically, the Commission erred in: (1) setting the highest offset factor at 5.3% based on unreliable data which USTA submitted on January 18, 1995; (2) eliminating the sharing obligation for carriers who choose an offset factor of 5.3%; and (3) setting the offset factor based on company-wide performance, rather than interstate operations only.

[1] *Price Cap Performance Review for Local Exchange Carriers,* First Report and Order, CC Docket No. 94-1, FCC 95-132 (released April 7, 1995) ("First Report and Order").

I. THE COMMISSION SHOULD RECONSIDER ITS RELIANCE ON USTA'S LATE FILED PRODUCTIVITY DATA IN SETTING THE HIGHEST OFFSET FACTOR; 5.3% IS TOO LOW TO SERVE AS THE HIGHEST OFFSET FACTOR.

The First Report & Order reasoned that because of a wide range of telephone company operating results (referred to in the First Report & Order as "heterogeneity"), the interim adjustment to the price cap formula should include three offset factor options. According to the First Report & Order, this approach will result in each LEC likely choosing the option which is closest to its own implicit X-Factor.[2] The minimum X-Factor is 4% and the optional X-Factors are 4.7% and 5.3%.[3] The Commission arrived at the 4% minimum X-Factor by excluding a 1984 data point from the Frentrup-Uretsky Study, averaging the results of the corrected study with those from a long-term study, and then adding a 0.5% Consumer Productivity Dividend ("CPD").[4] The method used to derive the 4.7% option is not apparent from the First Report & Order, but is not a matter of immediate concern for the Ad Hoc Committee because none of the major Local Exchange Carriers ("LECs") have opted to operate under the 4.7% offset factor. The 5.3% offset factor seems to be based on USTA's eleventh hour *ex parte* updates to its TFP Study, adjusted for the input price differential and a 0.5% CPD.[5]

---

2 *Id.* ¶ 213.

3 *Id.* ¶ 214.

4 *Id.* ¶ 209.

5 *Id.* ¶ 207 & Appendix F.

The First Report & Order provides absolutely no explanation (rational or otherwise) for relying on USTA's updated TFP Study and is silent regarding the filings that criticized the USTA updates. Paragraph 126 and footnote 130 of the First Report & Order, partially summarize substantive defects in USTA's updates identified by parties, including the Ad Hoc Committee. But neither the First Report & Order nor Appendix F to the First Report & Order does anything more than summarize the criticisms. The Commission does not even state that it has rejected the criticisms. Nor, of course, does the First Report & Order explain why the criticisms are misplaced in the Commission's view.

Yet the criticisms apparently *were* rejected since the Commission appears to rely on the USTA updates. Appendix F to the First Report & Order states, ". . . based on the latest data available from Christensen [USTA's TFP expert] and the BLS, we find that such an X-Factor, excluding the consumer productivity dividend (CPD), would be at least 4.8 percent."[6] (Emphasis added.) The Commission states that the updated USTA TFP Study uses data containing "significant revisions" to the earlier study.[7]

The Commission's failure to address the substantial criticisms of USTA's revised TFP Study constitutes arbitrary and capricious decision-making. Similarly, the Commission's failure to explain its reasons for relying on USTA's

---

[6] *Id.* at Appendix F, p. 2. Appendix F at p. 14 finds, "Relying on Christensen's and BLS's latest data, the X-Factor (excluding the CPD) for the 1984-1990 period is 4.8%." (Emphasis added.)

[7] *Id.* at Appendix F at 10.

updated TFP Study in setting the highest offset factor also reflect arbitrary and capricious decision making.

Assuming *arguendo* the lawfulness of setting interstate rates pursuant to a formula which relies upon a measurement of total company productivity,[8] the Commission should not have set the highest offset factor at 5.3% based on USTA's updated TFP Study. The Ad Hoc Committee and other parties pointed to unexplained data inconsistencies in USTA's updated study and explained why the data were unreliable. Similar complaints were not made with respect to the data underlying the TFP Study which USTA submitted in the first half of 1994. The First Report & Order does not explain why the data underlying this study is less reliable than that underlying the updated study. The Commission should have utilized the data underlying USTA's 1994 TFP study in setting the highest offset factor. If the Commission had applied the same methodology as it uses in the Order and Appendix F, but used USTA's 1994 TFP study data, it would have prescribed 5.7% as the highest offset factor. Accordingly, the Ad Hoc Committee respectfully requests that the Commission reconsider its decision to adopt 5.3%, rather than 5.7%, as the highest optional offset factor in its LEC price cap rules.

---

8 Total company productivity is a single productivity measure that aggregates interstate and intrastate operations, rather than one which measures only interstate productivity.

II. THE FIRST REPORT AND ORDER FAILS TO ESTABLISH A RATIONAL BASIS FOR ELIMINATING THE SHARING OBLIGATION UPON SELECTION OF 5.3% AS THE OFFSET FACTOR.

The First Report & Order does not establish a rational basis for eliminating the sharing obligation for LECs who opt to operate under a 5.3% offset factor. The only apparent reason given for the decision to eliminate the sharing obligation is the Commission's statement that a 5.3% offset factor is two percent higher than the offset factor under which almost all LECs now operate and in the short term will be a major challenge to LECs.[9]

An offset factor of 5.3% will not "challenge" most LECs. USTA's 1994 TFP Study data show that on an industry-wide basis LECs experienced combined productivity growth and input cost reduction rates that on average were 5.2% greater than the economy. The 5.2% figure obviously does not include the Consumer Productivity Dividend. Once it does, the appropriate offset factor would be 5.7%. Thus, the First Report & Order eliminates the sharing obligation for LECs who believe that they will exceed their post-divestiture experience by only 0.1%. To suggest that a combined productivity gain and input cost reduction of only 0.1% is a "challenge" is patently ridiculous--even if the First Report & Order is in effect for only one year. The fact that five of the seven RBOCs, the Sprint local exchange companies and many of the GTE companies selected the 5.3% offset factor in their annual access tariffs strongly

---

9 *Id.* ¶ 220.

suggests that 5.3% is not a significant challenge to the majority of price cap LECs. As long as the Commission retains 5.3% as the highest offset factor, the Commission should retain a sharing obligation for those carriers who decide to operate under the 5.3% offset factor.

The First Report & Order's arbitrary treatment of the sharing issue is also reflected in the very different way in which the Commission would treat LECs who choose 5.3% compared to those LECs who might have chosen 4.7%. Under the First Report & Order, LECs choosing the 4.7% offset factor would be allowed to keep all earnings up to 12.25% and 50% of their earnings to 16.25%. In effect, they would be allowed a rate of return of 14.25%. LECs choosing the 5.3% offset factor, on the other hand, would be allowed unlimited earnings.[10] Put differently, by opting to operate under an offset factor that is only 0.6% higher than one under which the effective rate of return may not exceed 14.25%, LECs would have unlimited earnings potential. Nothing in the First Report & Order, explains why the challenge presented by an additional increase of 0.6% so stretches the LECs that it assures that the LECs' returns will not be excessive under 5.3%. Indeed, by selecting the 5.3% X-Factor, LECs have demonstrated that they expect earnings to exceed 14.25, and perhaps by a significant amount.

Elimination of sharing for LECs that choose 5.3% also is arbitrary because the First Report & Order fails to explain why the elimination of sharing for these carriers under the interim plan is consistent with the Commission's prior

---

[10] *Id.* ¶ 200.

decision on the need for sharing. The First Report & Order explains that:

> The purpose of the backstop mechanisms [sharing and low end adjustment] was to help ensure that LEC price cap rates remained reasonable in the event that the X-factor was in error for the industry as a whole or, as a result of variations across the industry, for individual LECs. ... If the productivity growth of an individual LEC varied substantially from the industry average, the backstop helped keep its rates within a range of reasonableness.

First Report & Order, paragraph 185. Even if it is assumed for purposes of discussion that an offset factor of 5.3% will sufficiently limit the earnings of the LECs as an industry, there is no logical reason why it will ensure that the rates of individual LECs "within a range of reasonableness." The First Report & Order does not explain the reason for the Commission's change in policy regarding the need for the sharing mechanism to assure the reasonableness of individual carriers' rates. When administrative agencies change policies, they must provide a reasoned explanation of the change. The Commission has not done so in this case, and its failure to do so constitutes arbitrary decision making.

The Commission's decision making is no less arbitrary by characterizing the decision as "interim." LECs could enjoy excessive rates even if the "interim" plan is only in effect for one year. Indeed, it is quite likely that some LECs will realize excessive returns because the industry average offset for the post-divestiture period is 5.2% based on USTA's 1994 TFP Study.[11] The Communications Act shields customers from excessive rates. The Act does not carve out an exception for "interim" rates.

---

[11] As noted at pages 2-4, *supra*, the Commission cannot rely on USTA's updated TFP study.

The First Report & Order rejected the Ad Hoc Committee's argument that the Commission could not eliminate sharing because of the statutory requirement that carriers' rates be just and reasonable.[12] The Commission, however, fails to address the crux of the Ad Hoc Committee's concerns.

The First Report & Order acknowledges that the Communications Act requires just and reasonable rates. However, the Commission then argues that the Communications Act does not require that the Commission use any specific method to assure that carriers' rates be just and reasonable.[13] According to the Commission:

> Various methods may be used to set rates, provided the total effect is just and reasonable . . . Ending the backstop only for LECs willing to elect a substantially higher X-Factor represents a continued careful step toward improving the LEC price cap plan, strengthening the productivity incentives of the plan while assuring reasonable rates during the interim period it is expected to be in place.[14]

While the Commission surely has flexibility in selecting the methods it will use to assure that carriers' rates are just and reasonable, it may not regulate carriers' rates without regard to whether the carriers' earnings are within the zone of reasonableness. The Ad Hoc Committee submits that the zone of reasonableness cannot be determined without reference to the cost of capital and the carriers' earnings compared to the cost of capital. And, of course, the

12 47 USC § 201(b).

13 First Report & Order at ¶ 225.

14 *Id.* ¶ 225.

earnings cannot be determined without considering the carriers' cost of service. If the First Report & Order is arguing at paragraph 225 that a 5.3% X-factor will assure that no carrier subject to the Commission's jurisdiction will earn in excess of the zone of reasonableness, the argument has no factual foundation for all of the reasons set forth above.

Moreover, the First Report & Order provides no indication of what earnings level might be beyond the just and reasonable level. Presumably, it is above 14.25% because the Commission has affirmatively concluded that earnings at that level will be permissible.[15] But what are the limits on carriers' earnings under the Communications Act given contemporary conditions, including the cost of capital? If in paragraph 225 the Commission is attempting to evade the issue of whether <u>any</u> level of return would be excessive for carriers who select the 5.3% X-Factor, the Ad Hoc Committee requests that the Commission reconsider that portion of the First Report & Order. While the Commission may have flexibility in selecting the methods it uses to assure that carriers rates are just and reasonable, it may not sever the link between carriers' rates and the carriers' cost of service, including the cost of capital. To the extent that the Commission believes that it has expressed a contrary view in the First Report & Order, the Ad Hoc Committee respectfully requests that the Commission reconsider that aspect of the First Report & Order.

---

15 The Commission, however, has never attempted to explain the basis for its implicit judgment that returns of 14.25% are just and reasonable.

For all of the aforementioned reasons, the Commission should reconsider its decision to eliminate the sharing obligation for LECs who elect to operate under a price cap formula that uses a 5.3% offset factor. The Commission has identified no rational basis on which it can claim that the 5.3% X-Factor will ensure that LECs generally, or specific LECs, will not enjoy excessive returns. Accordingly, this portion of the First Report & Order is arbitrary, and therefore violates the Administrative Procedures Act and is inconsistent with the Communications Act.

III. THE COMMISSION ERRED IN SETTING THE OFFSET FACTORS FOR INTERSTATE SERVICES BASED ON TOTAL COMPANY PERFORMANCE.

The First Report & Order tentatively concluded that the Total Factor Productivity for purposes of setting the X-Factor should be calculated on a total company, rather than on an interstate basis.[16] The First Report & Order also used a measurement of total company TFP in setting the 5.3% optional X-Factor. In so doing, the Commission rejected arguments advanced by AT&T, MCI and the Ad Hoc Committee.[17] To justify this decision, the First Report & Order

---

16 First Report & Order at ¶ 159.

17 Indeed, Ad Hoc has shown that the LECs interstate TFP rate is higher than their company-wide TFP rate. Letter from Colleen Boothby, Ad Hoc Telecommunications Users Committee, to William F. Caton, *ex parte* presentation in CC Docket No. 94-1 at Attachment 1, p. 1 (February 14, 1995) ("Ad Hoc Ex Parte").

argues that:

> No party has argued that the production functions (the technological relationship between inputs and outputs) significantly differ for intrastate and interstate services in ways that can be readily measured or separated. Indeed, intrastate and interstate services are largely provided over common facilities. We therefore tentatively conclude that TFP should be calculated on a total-company, rather than interstate, basis.[18]

The Commission's stated reasons for calculating LECs' TFP rate for purposes of setting interstate rates on a total company basis is factually in error and inconsistent with applicable law.

As the Commission obviously knows, Total Factor Productivity is the difference between the annual change in inputs and the annual change in outputs.[19] Assuming *arguendo* that the production inputs are similar for interstate and intrastate services, that does not mean that interstate and intrastate services share the same TFP rate. The interstate TFP rate is higher than the LECs' intrastate TFP rate, because if for no other reason, demand for interstate services has grown faster than the demand for intrastate services.[20] Moreover, contrary to the Commission's description of the record in this docket, the Ad Hoc Committee challenged the notion that interstate and intrastate services have the same input factors because of a variety of differences between them.[21] For example, the mix of services subject to interstate jurisdiction is likely

---

18 First Report & Order at ¶ 159.

19 *Id.* ¶ 12.

20 Ad Hoc Ex Parte, Attachment 1, p. 2.

21 *Id.*

to be less labor intensive than the average for all LEC intrastate services. The First Report & Order does not even address these arguments. Accordingly, the Commission should reconsider its decision to use company wide TFP data, rather than interstate only TFP data, in setting the highest optional X-Factor.

The Commission's decision to rely on total company TFP data in setting the 5.3% optional X-Factor is also inconsistent with the Supreme Court's teaching in *Smith v. Illinois Bell Telephone Co.*, 282 U.S. 133 (1930). In *Smith,* the Court reasoned that "[t]he separation of the intrastate and interstate property, revenues and expenses of the company is important not simply as a theoretical allocation to two branches of the business. It is <u>essential</u> to the appropriate recognition of the competent governmental authority in each field of regulation." 282 U.S. at 148. (Emphasis added). The Court went on to observe that "[t]he proper regulation of rates can be had only by maintaining the limits of state and federal jurisdiction, and this cannot be accomplished unless there are findings of fact underlying the conclusions reached with respect to the exercise of each authority." 282 U.S. at 149.

The allocation of costs and revenue in *Smith* was a jurisdictional imperative. Without such allocation, carriers' rights to confiscatory regulation in a dual jurisdictional environment could be violated. Similarly, the users' right to be protected against exploitative rates would be endangered if carriers could recover all or some costs from both interstate and intrastate services. Although *Smith* obviously does not address the issue of whether carrier TFP rates must be calculated separately for interstate and intrastate services, it does speak to the need for jurisdictional allocations to avoid unlawful rates. In the instant case, TFP rates serve virtually the same function as the measurement of costs and revenues served in *Smith.* The carriers' TFP rate, the economy-wide measure of inflation, and exogenous cost changes are the factors which will determine the extent to which carriers must change their interstate rates, just as costs and revenues were of controlling importance in earlier eras. The Commission's reasons for using total company measures of productivity are similar to the argument that joint and common costs cannot be rationally allocated among jurisdictions. But yet the Supreme Court clearly requires that such allocations be made. That methods of regulation may have changed does not mean that public utility authorities, including the Commission, now can regulate without making the necessary jurisdictional allocations.

The Commission's failure to separately measure LEC interstate TFP raises the risk either that carrier property could be confiscated or that consumers of interstate services will be subjected to exploitative rates. In reality, it means that LECs will be allowed to charge excessive rates for interstate services. Accordingly, the Ad Hoc Committee requests that the Commission reconsider its decision to set the optional 5.3% X-Factor on the basis of company wide TFP data.

CONCLUSION

In view of the foregoing, the Ad Hoc Telecommunications Users Committee urges the Commission to reconsider partially the First Report & Order in this docket. As explained herein, the First Report & Order is arbitrary and capricious and violates the Communications Act. The Commission should not defer reconsideration of the relevant aspects of the First Report & Order pending conclusion of the Further Notice stage of this proceeding. Delay will unjustly enrich the price cap LECs and subject consumers to excessive rates for telecommunications services.

Respectfully submitted,

AD HOC
TELECOMMUNICATIONS
USERS COMMITTEE

By:

James S. Blaszak, Esq
Levine, Blaszak, Block &
Boothby
1300 Connecticut Avenue
Suite 500
Washington, DC 20036
202/223-4980

Economic Consultants
Dr. Lee Selwyn
Patricia D. Kravtin
Economics and Technology, Inc.
One Washington Mall
Boston, MA 02108-2617
617/227-0900

May 19, 1995

200.12/p4pr